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Analysis in Brief

Consumer Prices: The Year 2007 in Review

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Consumer Prices: The Year 2007 in Review

Alan Chaffe
Prices Division

Summary

Consumer prices accelerated slightly on average last year in Canada, but the rate of increase was lower than in most industrialized nations. The rate of inflation increased to 2.2% in 2007 as measured by the average annual Consumer Price Index (CPI). This increase was marginally faster than the average of 2.0% a year earlier.

The tight housing market, particularly in the resource-rich Western Provinces, combined with price increases for grain and gasoline exerted strong upward pressure on the all-items CPI. This pressure was tempered by lower prices for electronics and for purchasing and leasing passenger vehicles.

The real estate market remained an engine of economic growth in 2007, increasing shelter costs. Although the rise in shelter costs was slightly less pronounced in 2007 compared to 2006, thanks mainly to a decline in natural gas prices, they remained the primary contributor of the overall growth in consumer prices.

Price increases for basic and frequently-purchased commodities, like food, also fuelled consumer prices in 2007. However, price declines for a number of commodities, particularly several of those less frequently purchased, such as new vehicles and computer equipment, mitigated the rise in consumer prices. Faced with higher prices for frequently-purchased commodities and lower prices for those not frequently purchased, consumers might perceive that inflation was increasing at a faster pace than measured by aggregate inflation.

On a provincial basis, consumer prices varied considerably in 2007. In fact, provincial consumer prices experienced their greatest degree of divergence since 1994. Increases ranged from a high of 5.0% in Alberta to a low of 1.5% in Newfoundland and Labrador.

Compared with their counterparts in the rest of the world, Canadians actually came out ahead. On average, consumer prices for all member nations of the Organisation for Economic Co-operation and Development (OECD) advanced 2.5%.

Slight acceleration of consumer prices

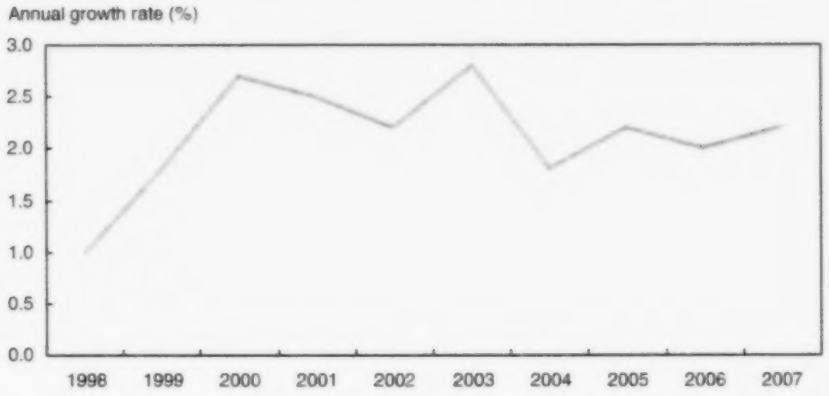
Consumer prices in Canada sped up slightly in 2007 advancing 2.2%, after rising 2.0% a year earlier. This was the fastest rate of growth since the 2.8% average increase in 2003.

Out of the eight major components in the Consumer Price Index (CPI) basket, consumer price increases in 2007 were driven up by increases for two of life's basic necessities: food and shelter. In 2006, costs for shelter and transportation were the major propellers of consumer price increases.

While food and shelter components represent about 43.7% of the total CPI basket of goods and services, they accounted for over 62% of the total increase in consumer prices in 2007.

Several economic fundamentals contributed to the overall rise in food and shelter, such as a tight housing market and a shift in the global demand for various commodities.

Chart 1 Consumer prices accelerate slightly



Source: Statistics Canada, CANSIM table 326-0021.

Rising mortgage interest costs and increases in prices for fruit juices, along with grain related food products, were the primary contributors to the increase in shelter and food components. Increasing gasoline prices were also a major contributor to the rise in consumer prices.

Increasing mortgage interest costs and gasoline prices were also responsible for creating the largest degree of divergence between the Bank of Canada's core index and the all-items CPI on record in 2007. Both of these components are included in the CPI but are excluded from the core measure.[1]

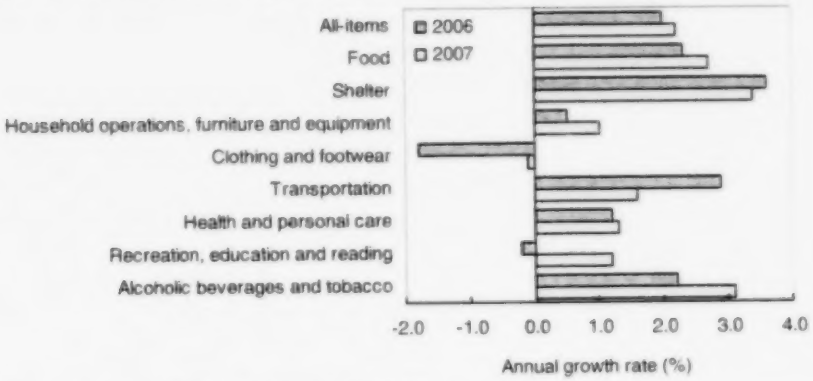
1. The core index is a special aggregate of the CPI and is used by the Bank of Canada as a policy instrument to conduct monetary policy with the aims of holding overall inflation at a 2.0% target level. The core index is computed by removing eight of the most volatile components of the CPI (fruits; fruit preparations and nuts; vegetables and vegetable preparations; mortgage interest costs; natural gas; heating oil and other fuels; gasoline; inter-city transportation; and tobacco products and smokers' supplies) and the effect of changes in indirect taxes from the CPI.

Price drops for several commodities, particularly those not frequently purchased, like computer equipment and new vehicles, helped to mitigate the rise in other consumer items. Lower prices for natural gas and clothing also helped to temper the overall CPI.

Among other factors, a strong Canadian dollar and imports of commodities from countries with favourable relative costs may have helped contain consumer inflation during the year.

The 0.2-percentage point acceleration in consumer prices from 2006 to 2007 was primarily due to rising costs for mortgage interest, passenger vehicle insurance and traveller accommodation. However, declines in prices for natural gas and to purchase and lease passenger vehicles, along with a significant deceleration in prices for electricity, moderated the acceleration in consumer prices from 2006 to 2007.

Chart 2 Growth rate of the eight major components of the Consumer Price Index



Source: Statistics Canada, CANSIM table 326-0021.

Hot housing market pushes up consumer prices

The robust real estate market remained an engine of economic growth in 2007 and gave rise to higher shelter costs. Although the rise in shelter costs was slightly less pronounced than in 2006, costs associated with shelter remained the primary contributor of overall growth in consumer prices.

Led by a robust gain in costs for owned accommodation (+4.9%), costs associated with shelter increased 3.4% in 2007, after rising 3.6% a year earlier. If shelter was excluded from the CPI, consumer prices would have risen only 1.7%.

Two factors contributed significantly to the rise in costs for owned accommodation: a 6.0% rise in costs associated with mortgage interest and a 5.9% rise in replacement cost (the cost of maintaining a housing structure, excluding land).

The rise in mortgage interest can be attributed largely to the growth in new housing prices and the larger mortgages that resulted, rather than the renewal or initiation of mortgage loans at higher rates. Excluding mortgage interest costs, the CPI would have advanced by only 1.9% in 2007. Higher new housing prices were also primarily responsible for pushing up homeowner's replacement costs.

Since the late 1990s, housing prices have been on an upward trend across major regions of Canada. Strong demand in comparison to the supply of housing, driven by an improvement in the financial position of households and low interest rates, has turned the housing market into an engine of growth for the economy and has put significant upward pressures on housing prices.

Housing construction levels have remained high in recent years. Information from the 2006 Census indicates that household formation rates increased significantly from 2001 to 2006. This suggests that strong demand has bolstered housing construction and prices in recent years.

The New Housing Price Index (NHPI)[2] advanced by a robust 7.7% in 2007 after climbing 9.7% a year earlier. Although gains were observed in all ten provinces, it was new home buyers in the Prairie Provinces—Saskatchewan (+31.2%), Alberta (+22.5%) and Manitoba (11.8%)—that were hit with the largest price increases.

Existing housing prices in Canada also posted hefty gains, advancing 11.0% in 2007, according to the Multiple Listing Service (MLS) residential average price.[3] Prices for existing homes followed trends similar to those for new housing across the country.

Higher mortgage rates played a marginal role in the cost associated with the mortgage interest increase. Overall, the five-year conventional mortgage rate averaged 7.1% for 2007, above the 6.7% average posted in 2006.

A steady run-up in fuel oil and other fuel prices beginning in September also drove up shelter costs. By the end of the year, consumers were paying 4.0% more to heat their home in 2007 than in 2006. Municipalities also had an impact on homeowners' costs as property taxes increased 3.2% and water rates rose 7.2%.

A robust 6.5% decline in prices for natural gas—the largest contraction recorded since the 18.1% drop posted in 2002—helped to offset the rise in shelter costs. Larger gas storage levels and a milder winter in 2007 were the primary reasons for low natural gas prices.

Despite a roughly 2.0% decrease in production in Canada, North American natural gas production advanced, thanks to strong US extraction activity.[4] Overall, the amount of natural gas in storage at the end of January 2008 was above the five-year average.[5]

Decelerating electricity prices also helped to moderate the rise in costs for shelter. After advancing 5.6% in 2006, prices for electricity increased by a more moderate 1.9% in 2007.

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2. The NHPI measures changes over time in the contractors' selling prices of new residential housing.

3. See the Canadian Real Estate Association, MLS Statistics, http://creastats.crea.ca/natl/ (accessed February 26, 2008).

4. In a given year, Canada produces about one quarter of the combined natural gas production in both Canada and the United States. Canada and the United States operate as one large integrated market and natural gas prices are determined by three factors: the price of natural gas itself (known as the commodity), pipeline transportations cost, and distribution cost. The later two are regulated by government agencies but the commodity cost varies based on supply and demand conditions that can vary wildly at any given time.

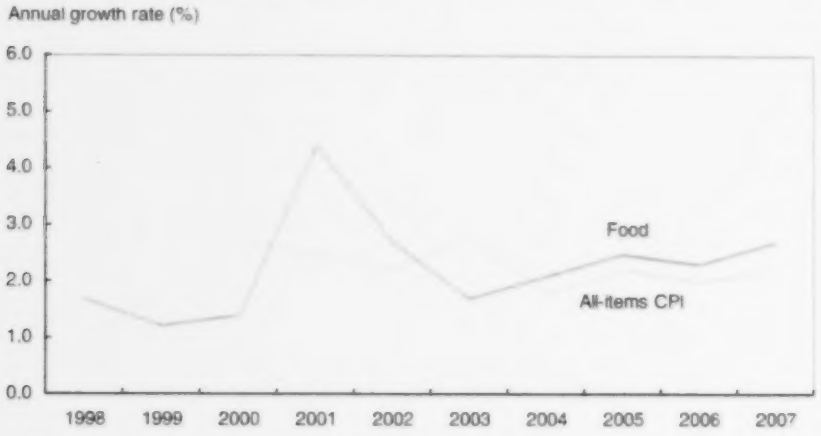
5. See the National Energy Board (NEB), *Current Market Conditions: April/May 2008, NEB: Pricing: Natural Gas*, http://www.neb-one.gc.ca/clf-nsi/rnrgynfmtn/prcng/ntrlgs/crrntmrktcndtn-eng.html (accessed April 16, 2008).

Food: Second fastest increase in 16 years

In 2007, Canadian consumers faced a 2.7% increase in prices for food, an acceleration from the 2.3% climb recorded a year earlier. Except for the 4.4% rise posted in 2001, a gain greater than this magnitude has not been witnessed since 1991.

Price increases for basic and frequently purchased commodities, like food, were fuelling consumer prices and were possibly causing individuals' perceptions of inflation to exceed rates measured by aggregate inflation.[6] Excluding food, the CPI advanced by a more moderate 2.0% in 2007.

Chart 3 Food prices outpace growth in all-items Consumer Price Index



Source: Statistics Canada, CANSIM table 326-0021.

A 13.0% rise in prices for fruit juices, primarily due to orange juice, propelled food inflation upwards. Poor weather conditions in 2007, combined with two major hurricane seasons compounded by drought and crop disease in the 2004/2005 and 2005/2006 crop years, challenged orange growers in Florida to maintain consistent production levels. Florida is the world's second-largest producer of juice oranges, behind Brazil.[7] A crop freeze in California at the beginning of 2007 also drove up orange and orange juice prices.

Increases in prices of several food products related to grain occurred in the wake of a surge in world grain prices. Grain prices increased substantially in 2007 as a result of a tight supply–demand situation for wheat, caused by poor northern hemisphere harvests and all-time low world wheat

6. Unfortunately, this hypothesis cannot be tested due to lack of data on inflation perception. However, a recent TD Financial Group Special Report entitled, "Say it ain't so: Canadians don't believe inflation numbers" notes that many Canadian's perception of inflation exceed aggregate inflation measures. http://www.td.com/economics/special/sc0706_infl.jsp (accessed June 19, 2008).

7. See Pollack, Susan and Agnes Perez, Fruit and Tree Nuts Outlook, November 2007, Economic Research Service, United States Department of Agriculture Publications, http://www.ers.usda.gov/Publications/FTS/ (accessed April 16, 2008).

stocks. World wheat stocks declined by about 9.7% in 2007, reaching the lowest level since the early 1980s.[8]

As measured by the Farm Product Price Index (FPPI), prices received by farmers for grain advanced by 51.4% in 2007—the highest recorded since data for grain prices were published in 1971.[9]

Prices for bread products were up 7.1% in 2007, identical to the rate of increase recorded in 2006. In contrast, prices for pasta and flour products accelerated in 2007. Pasta products rose 6.4% in 2007, up from the 0.6% increase recorded a year earlier. Flour and flour based mixes rose 1.5%, after recording no change in 2006.

An increase in prices for supply-managed commodities (dairy, chicken, turkey and eggs) also occurred in the wake of rising costs for grain. Consumers paid 3.6% more for dairy products and 6.6% more for fresh or frozen poultry meat products. The rise in dairy products was mostly due to a 4.4% increase in prices for milk. Egg prices also climbed 5.8% in 2007.

A 7.2% rise in prices for fresh or frozen chicken propped up overall poultry prices. Price increases for all other meats were more marginal, as prices for fresh or frozen meat excluding poultry rose by a more moderate 2.0%.

A strong Canadian dollar may have helped to contain food inflation. The price for imported food from the United States has been kept down, especially for most fruit and vegetables, helping to mitigate the rise in food prices. Prices for other fresh fruit fell 0.7% and the price of lettuce fell 2.1% in 2007.

An 11.7% reduction in prices for tomatoes and a 9.8% drop in prices for potatoes also helped to moderate the rise in prices for other food items. After increasing 28.5% a year earlier, prices for potatoes returned to more normal levels thanks to a good harvesting season in 2007. Likewise, a good harvest season for tomatoes in 2007 returned prices to more normal levels after rising 7.7% in 2006.

Rising food costs, especially for key inputs such as dairy and poultry products, translated into higher input costs for restaurants in 2007. Robust wage gains for food services and drinking places employees (+7.2%) also had an impact on restaurant owner's costs. In the wake of these increases, consumers paid 2.7% more for restaurant meals in 2007, identical to the rate posted in 2006.

Transportation: Strong dollar cushions price gains for new vehicles and gas

Despite soaring gasoline prices, the overall growth in the cost of transportation slowed to 1.6% in 2007, down from the 2.9% gain posted in 2006. Offsetting the 4.5% rise in gasoline prices was a 1.4% reduction in prices to purchase and lease passenger vehicles, thanks partially to a strong Canadian dollar.

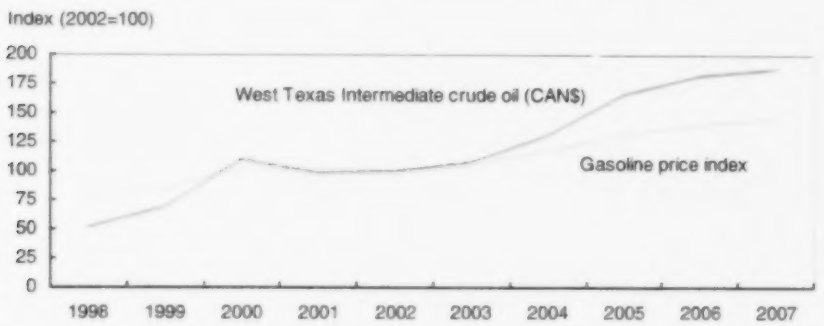
Energy markets will likely remember 2007 as the year when crude oil prices continued to climb to record highs, putting significant upward pressure on gasoline prices. After dropping in January,

8. Food and Agriculture Organization of the United Nations, Statistics, *Food Outlook*, November 2007 and December 2006, http://www.fao.org/giews/english/fo/ (accessed June 1, 2008).

9. The FPPI reflects the prices that farmers receive for the agricultural commodities they produce and sell.

crude oil prices climbed steadily over the year. Increasing global demand, combined with ongoing geopolitical tensions, uncertainty related to the hurricane season in key upgrading regions and record low inventories, sent the price of oil rising to new record highs in 2007.

Chart 4 Gasoline prices rise as crude oil prices climb to record highs



Source: Statistics Canada, CANSIM table 326-0021 and Economagic, *Spot Oil Price: West Texas Intermediate: Dollars per Barrel*, www.economagic.com/em-cgi/data.exe/fedstl/oilprice+1 (accessed April 14 2008).

The West Texas Intermediate (WTI) price of crude oil reached record highs in 2007, averaging US$72.36 a barrel, up 9.5% from 2006.[10] The weak state of the US economy towards the end of 2007 did nothing to assuage oil price increases. The appreciation of the Canadian dollar, however, helped to temper crude oil price increases for Canadian consumers. In Canadian dollars, the price of a barrel of oil reached a record $92.02 in December and averaged $76.86 over the year, a 2.6% climb from a year earlier.

Overall, gasoline prices rose by a robust 4.5% in 2007, after increasing 5.4% a year earlier. If gasoline were excluded from the CPI, consumer prices would have advanced by only 2.0%.

Also pushing up prices for transportation was a 4.3% rise in prices for passenger vehicle maintenance and repair services and a 4.0% rise in passenger vehicle insurance premiums.

Partially offsetting these increases was a 1.5% decrease in prices to purchase passenger vehicles. This is the fastest decrease observed since 1991, when the Canadian economy was in a recession. Prior to 1991, a decrease for this commodity had not been recorded since the 2.0% decline posted in 1966. A 1.3% price decline for leasing passenger vehicles also mitigated the rise in the Transportation Price Index.

Auto retailers and manufacturers offered numerous price incentives at the end of 2007. Also, a higher Canadian dollar triggered Canadian auto dealers to reduce the price gap between US and Canadian auto prices that led to record imports of vehicles from the United States at the end of 2007.

10. See Economagic, *Spot Oil Price: West Texas Intermediate: Dollars per Barrel*, "Economagic Time Series," www.economagic.com/em-cgi/data.exe/fedstl/oilprice+1 (accessed April 14, 2008).

Consumers face rising costs for travel tours and education

In 2007, Canadian consumers faced rising prices for travel tours and increasing costs for education.

A healthy domestic economy, coupled with an appreciating Canadian dollar and blustery winter weather, supported growth in international travel. Travel tour prices advanced 3.5% in 2007, a substantial reversal from the 1.8% and 1.0% decline recorded in 2005 and 2006 respectively.

Prices for travel tours are collected in January, February and March, when Canadians are more inclined to purchase travel tours. It was an increase in prices for travel tours in February 2007 that was primarily responsible for the rise in travel tour prices from 2006 to 2007. From January to February 2007, prices for travel tours rose 11.4% compared with the 8.0% rate of growth recorded over this same period in 2006. This is the highest increase since February 2004 and is a reflection of higher demand for winter vacations.

International travel of one or more nights increased 4.9% in February 2007 compared with February 2006. Overall, travel by Canadians increased by a healthy 6.7% in 2007 and was primarily the result of travel by plane to the United States and to other countries, which increased 8.2%.

Also putting upward pressure on consumer prices was a 3.0% climb in tuition fees. Apart from the 2.2% rise recorded for tuition fees in 2006, the rise in 2007 was the smallest climb posted since 1976. Since 1990, tuition has more than tripled (+236.6%) for students.

Price declines for electronics, clothing and footwear commodities help to contain inflation

Fierce competition, the strong Canadian dollar and a growing presence in Canada of imported goods from emerging Asia economies, in addition to quality enhancements, all continued to help reduce consumer prices for clothing, footwear and electronic items in 2007.

Prices for electronic items continue to fall thanks to fierce competition and rapid technological advancements and improvements in product features and quality. Computer and equipment prices fell by a hefty 17.1% in 2007, in line with the average price decline of 17.9% observed from 1997 to 2006.

The cost of both laptop and desktop computers fell because of continued declines in the prices of their components (e.g., LCD screens, processing units, etc.) and improved quality enhancements.

Prices for video equipment and photographic equipment and supplies followed similar trends, falling 9.2% and 9.7% respectively. Prices for photographic equipment fell as a result of large price drops for digital cameras. Continuous quality improvements are primarily responsible for the decline in prices for electronic commodities.

Declines in prices for clothing and footwear also helped to contain consumer inflation in 2007. After contracting for the previous five years, clothing prices continued their downward trend in 2007, falling 0.8%. Similarly, footwear prices fell 0.7% in 2007, continuing a downward trend that began in 2002.

Strong competition among retailers, a strong Canadian dollar and a growing presence of imported clothing and footwear items from emerging Asia economies helped to contain price increases for these items.

Imports of clothing and footwear from China, a low-cost producer, have been increasing while more costly imports from the United States have been on the decline since 1999. Imports of clothing from China have increased at a compounded annual growth rate of 18.3% since 2001. During the same period, footwear imports from China rose at a compounded annual growth rate of 6.1%.

The price of imported goods directly affects the CPI. As Canadians substitute towards more goods and services from China and away from relatively more expensive clothing and footwear items from the United States, the price index for clothing and footwear will decline, all other factors constant.[11]

A 3.6% increase in dry cleaning service costs dampened the contraction in clothing and footwear prices. More significantly, however, was a 4.6% rise in the price of jewellery that mitigated the fall in this index. Jewellery retailers have been hit hard by soaring prices for precious metals that are used to produce their goods.

After jumping 31.3% in 2006, prices paid by Canadian manufacturers for precious metals rose 9.4% in 2007. Since 2000, prices paid by Canadian manufacturers for precious metals, as measured by the Raw Materials Price Index, have nearly doubled, increasing by over 80%.

The provinces: Alberta responsible for largest provincial disparity since 1994

Consumer prices vary from province to province, and even from town to town. Provincial disparities were abundantly clear in 2007, the result primarily of differing rates of growth for shelter, particularly in Alberta. In fact, the all-items CPI experienced the greatest disparity among the provinces since 1994.

Albertans experienced a relatively strong growth in consumer prices (+5.0%), more than twice the national average (+2.2%). This is the widest gap since the inception of the provincial all-items indexes in 1980.

A 2.8% rise in consumer prices in Saskatchewan and more moderate increases in Newfoundland and Labrador (+1.5%) and Quebec (+1.6%) also contributed to the large dispersion in consumer prices across the country.

If Alberta were excluded, the all-items CPI would have advanced by a more modest average of 1.9%. This is identical to the average rate of growth posted in 2006, again if Alberta was excluded.

Differences in increasing costs for shelter were largely responsible for this big disparity among the provinces. In 2007, shelter cost increases ranged from a mere 1.6% in Nova Scotia to 12.2% in Alberta.

This large discrepancy in the growth of shelter costs was due primarily to differences in costs for owned accommodation. Owned accommodation rose by a hefty 15.1% in Alberta and 13.0% in Saskatchewan, and a more modest 5.2% in Manitoba.

New Brunswick recorded the slowest growth in owned accommodation with a growth rate of 2.2%, followed by Prince Edward Island and British Columbia, both of which posted a 2.7% rise.

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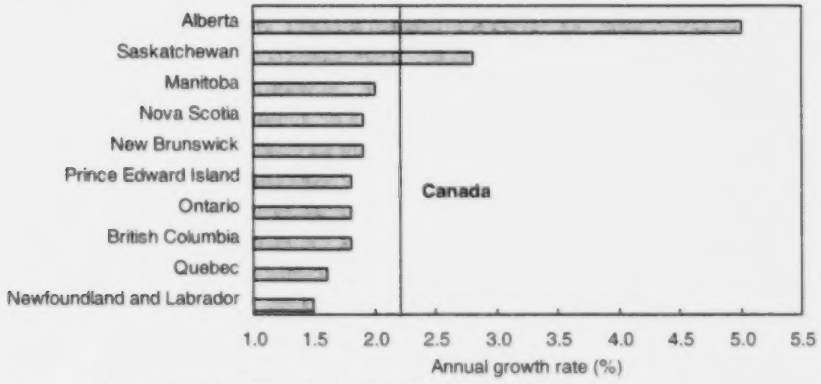
11. For a detailed study on the impact of foreign goods on Canadian consumer inflation see Louis Morel, "The Direct Effect of China on Canadian Consumer Prices: An Empirical Assessment," Bank of Canada Discussion Paper 2007-10, September 2007.

When shelter costs are excluded, the growth rate in consumer prices in Alberta is more in line with the overall rate of growth in the CPI experienced across the country. Excluding shelter costs, the CPI in Alberta advanced 2.3%, more comparable to the 1.7% rate of growth nationally, also excluding shelter.

Prices for shelter and food drove up overall consumer prices in every province. While shelter costs varied considerably, increases in food prices were more comparable across provinces. Consumers in Prince Edward Island were hit with the largest price increase for food (+3.4%), followed by those in Saskatchewan (+3.3%) and Alberta (+3.3%). Residents of Newfoundland and Labrador and Quebec paid 2.3% more for food in 2007 than in 2006.

Chart 5 Large difference in consumer price increases between Alberta and other provinces in 2007



Source: Statistics Canada, CANSIM table 326-0021.

Consumer prices higher in most other countries

Most consumers around the world dealt with higher price increases in 2007. While rising costs for food and energy were a major driver of consumer price increases in Canada, Canadians were not alone; countries around the world grappled with soaring food and energy costs that contributed significantly to consumer price increases.

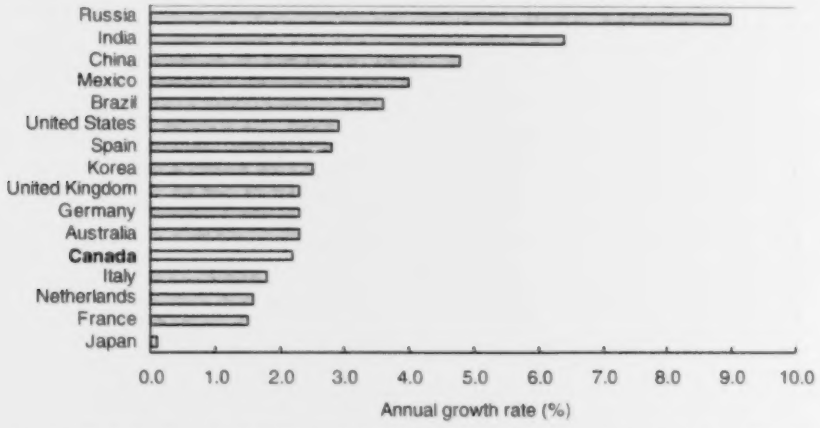
Compared with the world's 16 largest economies, Canada's consumer price increases placed near the bottom of the pack.[12] With an inflation rate of 2.9%, the United States experienced higher consumer price increases compared with Canada. In Japan, consumer inflation barely budged (+0.1%). Consumer prices for all OECD countries rose 2.5% in 2007.

While rising food costs were a major driver of increases in consumer prices in Canada in 2007, countries around the world also grappled with rising food costs that contributed significantly to inflation. It would appear, however, that the strong Canadian dollar somewhat insulated Canadian

12. The worlds 16 largest economies was determined by ranking each country by real GDP in 2006 using data from United Nations, Statistical Division, GDP and its breakdown at constant 2000 prices in US dollars for all countries, http://unstats.un.org/unsd/ (accessed April 16, 2008).

consumers from the surge in food prices, as consumers in other parts of the world faced higher food inflation in 2007.[13]

Chart 6 Consumer price increases in Canada near the bottom of the pack, 2007



Source: Statistics Canada, CANSIM table 326-0021 and OECD, Consumer price indices (MEI), http://stats.oecd.org/wbos/Index.aspx?querytype=view&queryname=221 (accessed April 16, 2008).

Increased transportation costs, bad weather and growing demand for food from emerging Asia economies are among the many reasons for higher food prices across the world.

Rising costs for energy also weighed heavily on consumer inflation around the world. Although energy prices for OECD countries cooled to a growth rate of 4.0% in 2007, down from the 9.3% recorded a year earlier, energy was still a driving force of overall price increases around the globe thanks to increasing oil prices. Americans faced the highest rate of growth in prices for energy, as energy prices there advanced 5.5% after climbing 11.2% a year earlier.

Canadians, however, faced only a 2.3% rise in energy costs in 2007, down from the 5.1% posted in 2006. The strong Canadian dollar, which mitigated the rise in the cost of crude oil, a decline in natural gas prices and a substantial slowdown in the growth in electricity prices moderated the rise in Canada.

13. European Union (+3.5%), United States (+4.2%), United Kingdom (+4.5%), Mexico (+6.5%), China (+12.3%). See Statistical office of the European Commission (EUROSTAT), Harmonized Indices of Consumer Prices, http://epp.eurostat.ec.europa.eu (accessed April 16, 2008); Organisation for Economic Co-operation and Development (OECD), Consumer Price Index for OECD Countries and Major Non-member Economies, Purchasing Power Parities: Statistical Portal, http://stats.oecd.org/wbos/Index.aspx?querytype=view&queryname=221 (accessed April 16, 2008); and the National Bureau of Statistics China, Statistical Data, Consumer Price Index, http://www.stats.gov.cn/english (accessed April 16, 2008).